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ECONOMIC OUTLOOK

Chamber of Commerce of the United States

January/February 1985

POLICY CERTAINTY WOULD MAKE THE CRYSTAL BALL CLEARER

by
Richard W. Rahn

As the old adage has it, "the only thing certain about an economic forecast is that it will be *wrong*. The only question is, in which direction, and by how much." Over the last couple of years, the supply-side economists, and in particular, the U.S. Chamber, have been less wrong than most other forecasters. During the same period, the major econometric models fared even more poorly than the consensus forecast. Using the latest GNP revisions and the forecasts reported in the December 1982 and December 1983 issues of *Blue Chip Economic Indicators*, the following table summarizes recent forecasting records.

We attribute our superb forecasting performance to the fact that we believe that policies largely determine outcomes, and that incentives are important. In our forecasts for 1983 and 1984, we incorporated our views that the fiscal policy changes which became effective under the 1981 Economic Recovery and Tax Act (ERTA) would have a tremendous beneficial impact on investment incentives. In addition, we felt that the positive effect of lower marginal tax rates in increasing investment and work effort would largely offset the negative implications of the prevailing high deficits and real interest rates. We added these judgemental elements into the usual quantitative analysis and emerged with forecasts which have consistently placed us on the optimistic end of the range, but which also proved to be more correct than most. In fact, as the table above shows, we erred by not being optimistic enough!

As you will note in the article that follows, our forecast continues to be considerably more optimistic than the consensus. Despite our optimism, however, we believe that the economy will not reach its potential because of sub-optimal policies by the Fed, the Congress, and the Administration. Thus, over the next few months, we will continue to describe and advocate policy changes that could make our high growth scenario (see the October and December issues of ECONOMIC OUTLOOK), a reality.

COMPARISON OF FORECASTING RECORDS FOR 1983 AND 1984

REAL GNP (1983 & 1984)

	Dec. 1982 for 1983	Dec. 1983 for 1984
Actual Outcome	3.7%	6.8%
U.S. Chamber of Commerce	3.1%	6.1%
error(a)	-0.6	-0.7
Consensus Forecast	2.8%	5.4%
error(a)	-0.9	-1.4
Average of Major Econometric Models	2.2%	5.2%
error(a)	-1.5	-1.6

(a) Percentage point difference between forecast and actual outcome. A negative error denotes an underestimate.

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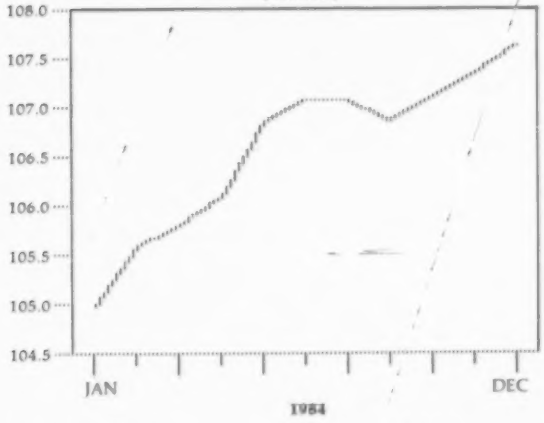
1985: THE YEAR OF THE OX

by
Ronald D. Utt and Graciela Testa-Ortiz

According to the Chinese calendar, 1985 is the year of the ox. Although we are used to describing markets as either bulls or bears, the ox may be the more appropriate characterization for 1985. Following one and half years of above average vigor, the U.S. economy shows all signs of having settled into a sustainable period of strong, healthy growth. Like the ox, the economy has become an extremely tractable animal.

Following the usual rumblings of impending doom and stagnation from the usual claque of forecasters during the last half of the year, 1984 ended on a very positive note. While the small uptick in the December unemployment rate was expected due to problems with seasonal factors, the 341,000 new jobs created in the nonfarm sector reflect the continued strength of the U.S. economy. Chart 1 shows that, except for a lull in the middle of the year, nonfarm employment rose sharply in 1984. Disposable income rose in tandem with

CHART 1
Total Nonfarm Employment
During 1984
(Millions)



it, growing by 7.3 percent in 1983 and 10.2 percent in 1984. Since consumer price increases averaged only four percent last year, the improvement in nominal income translated into a 6.8 percent real increase. The continuing slide in interest rates, combined with increases in employment and real disposable income, have resulted in a very optimistic American consumer. A recent Gallup Poll noted that 61 percent of the Americans surveyed thought that 1985 would be a "better" year than 1984. Gallup concluded that the "U.S. optimism is due in considerable measure to the public's bullish views about the economy."

This optimism was reflected in personal consumption expenditures which, as Chart 2 shows, rose significantly during 1984. Excluding food and gasoline outlets, retail sales rose by one percent in December, and the respondents to the Chamber's retail sales survey noted that the Christmas selling season was quite good. Domestic car sales ended 1984 with a strong surge, averaging 8.3 million units in December compared to 6.9 million and 7.1 million in October and November, respectively (see Chart 3). As we anticipated, the decline in interest rates continues, with the prime rate falling to 10.5 percent in mid-January. New housing starts, reacting to the decline in interest rates, began to recover.

CHART 2
Personal Consumption Expenditures
During 1984
(Billions of Dollars)

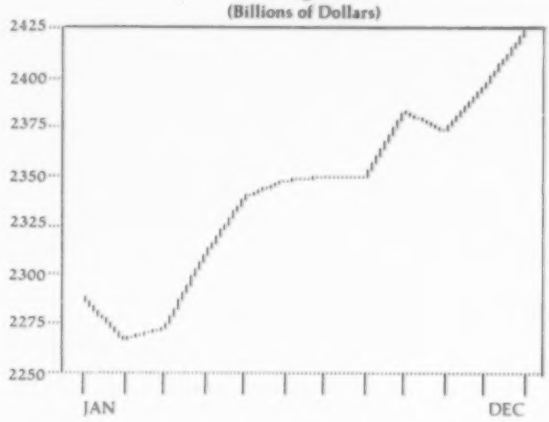
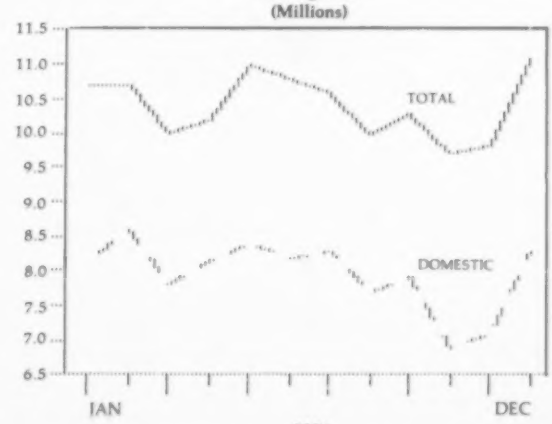


CHART 3
New Car Sales
During 1984
(Millions)



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This high level of confidence by the consumer was reflected in total output, as the index of industrial production rose 0.6 percent in December. And, in spite of the lackluster performance of overall real GNP during the last half of the year, business fixed investment continued to grow at double-digit annual rates. Finally, the news on the inflation front remains encouraging. Producer prices for finished good rose by only 1.8 percent in the past twelve months, and the general price level (the implicit deflator for GNP) rose by 3.7 percent.

Reflecting our continued optimism, this month's forecast is similar to last month's—1985 will be a year of above average growth. Since we did not downgrade our anticipations for 1985 and 1986 as a result of the third quarter's weakness, there is no need to upgrade it, now that it is becoming apparent that the third quarter's lull did not signal the beginning of a trend. Real GNP is expected to grow by 4.6 percent in 1985 and 5.1 percent in 1986; quarterly growth rates are forecast to remain close to an annual rate of five percent this year and next. Spurred by continued declines in interest rates, the investment sector, both residential and nonresidential, is anticipated to remain the driving force in the nation's economy. A partial exchange rate adjustment and increased strength in our major trading partners can be expected to support a rise in real exports in 1986.

Financial Factors and Investment

One key factor that leads us to be optimistic about the 1985 outlook is the dramatic declines in interest rates since late summer. Perhaps finally reflecting the Federal Reserve's resolve to maintain price stability and the likelihood that monetary conditions would soon be eased, all market interest rates peaked in mid-summer and went into free-fall beginning in September. By late January, the 90-day Treasury bill rate fell to 7.68 percent, the lowest rate in two years.

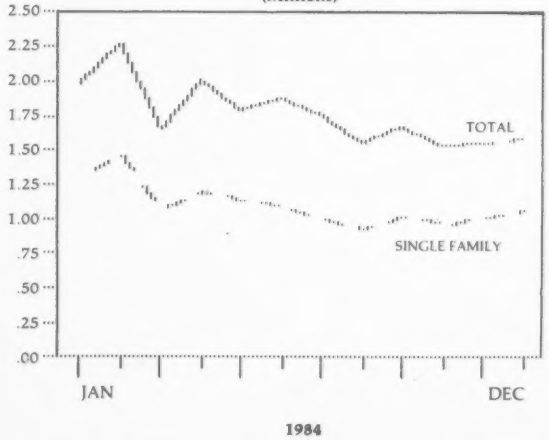
In addition to the effects of a more accommodative monetary policy and greatly diminished inflationary expectations, the increased availability of funds also contributed to the decline in interest rates. In 1984, the personal savings rate jumped to 6.1 percent of disposable income, up from just five percent in the preceding year. This amounted to an additional $39 billion in savings as consumers curbed their spending and finally increased their savings in response to higher incomes and tax incentives. Corporate profits, another important source of national savings, also increased significantly during the year. Data for the third quarter of 1984, the most recent available, indicates that profits were running $43 billion ahead of the same quarter a year ago.

By way of comparison, the magnitude of the interest rate decline closely matched the sharp fall in interest rates that occurred in late 1982 and preceded the powerful recovery which emerged in early 1983. Because of these sharply lower rates, we have every reason to believe that early 1985 could see a similar pick-up in economic activity as lower rates stimulate interest-sensitive sectors such as automobiles, housing, and business fixed investment.

Mortgage interest rates, which peaked last July at 14.85 percent, fell steadily through the year and reached 13.34 percent by early December, the lowest these rates had been since February, 1984. As a result, residential housing reversed the decline that began in mid-1984 and with mortgage rates projected to fall further, housing starts should rise to 1.9 million by the end of the year. This would imply an 18.8 percent gain from current levels of production. This forecast, however, is contingent upon there being no significant changes in tax law as it affects real estate investment.

Single family starts tracked the ups and downs of interest rates fairly closely but with about a three month delay. Reaching their peak during the first quarter, starts fell sharply during the year before bottoming out in August and October (see Chart 4). Since then, steady but moderate gains have been made which should accelerate in 1985 in response to lower mortgage rates and increased availability of funds from traditional mortgage lenders. Multifamily starts (apartments and condominiums) have continued to fall through the year, reaching their low point in December, but we are optimistic that they, too, will rise. However, it is possible that uncertainty regarding tax law as it affects commercial real estate, and a relatively high vacancy rate could depress activity in this important area.

CHART 4
New Housing Starts
During 1984
(Millions)



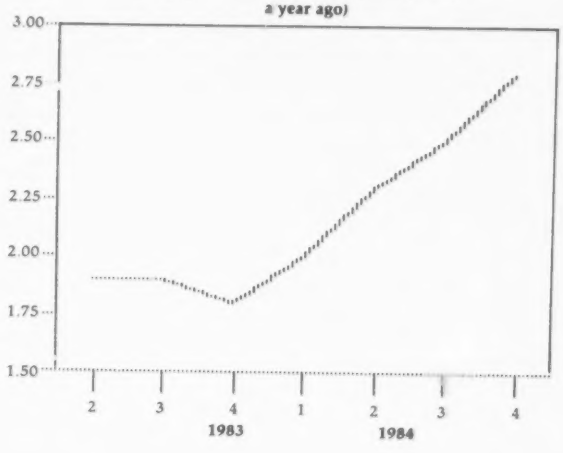
Nonresidential business fixed investment should also respond favorably to the decline in interest rates and sustain what, so far, has been the strongest capital spending boom of the postwar era. Although business investment spending in 1984 grew at the fastest rate in thirty-eight years, it also showed weakness toward the end of 1984, recording an 11.1 percent gain at an annual rate in the fourth quarter compared to increases in excess of twenty percent for the first half of the year. As in the case of residential housing, business fixed investment closely tracked interest rates with a delay of three to six months. Triple-A corporate bond rates, which peaked in late June at 13.71 percent, have fallen steadily during the year to about 12.2 percent at present. This is as low as they have been since late 1983 and the first two months of 1984. As a result, double-digit rates of growth in capital spending should continue during 1985. Factors other than a more favorable interest rate climate that will help support strong rates of capital spending growth include high levels of corporate cash flow and the pressing need for American business to maintain rapid productivity growth to meet the challenge of aggressive foreign competition.

For most analysts and forecasters, the decline in interest rates was totally unexpected. In the July, 1984 issue of *Blue Chip Financial Forecasts*, a monthly compendium of interest rate projections by prominent forecasters, 32 of the 40 participants believed that the prime rate in the fourth quarter of 1984 would be 13 percent or greater. Instead, it averaged 11.8 percent and reached a low of 10.75 percent in the final week of the year. With short-term money rates still falling, we expect further declines in the prime rate over the next few months and estimate that it will go as low as 9.3 percent by the end of 1985. Regular readers will remember that the Chamber's Forecast Center has consistently taken the minority view that rates would fall by the end of 1984 and, happily, again called the turn in this important indicator. And, as has so often been the case, the actual outcome was considerably more optimistic than even we had guessed.

Inflation, Capacity Utilization and Productivity

We have just completed a second year of very low inflation compared to the experience of the past decade and all signs point to a continuation of that trend during this year and next. Thanks to moderate rises in wages and relatively strong productivity gains, unit labor cost increases were held down to 1.3 percent in 1983 and 1.4 percent in 1984. Stronger wage pressures, as unemployment continues to subside, are expected to push the growth rate of employee compensation up during this year and next, but continued productivity improvements, averaging 2.4 percent in 1985 and three percent in 1986, will offset their impact on labor costs. Capacity utilization remains well below the level that might be expected to contribute to bottlenecks and shortages, and ultimately, to increased price pressures. In fact, as Chart 5 shows, the nation's industrial capacity has risen steadily since mid-1983. At the end of 1984 the Federal Reserve Board's index of capacity was 2.8 percent higher than its level at the end of 1983.

CHART 5
Federal Reserve Board's Index of Capacity
(percent change from the same period, a year ago)

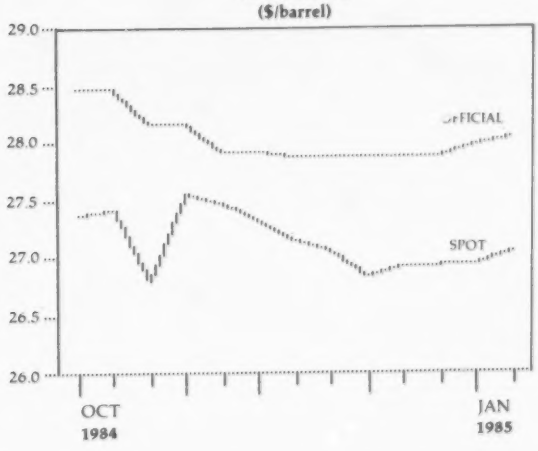


Crude oil prices, a major contributor to the inflation of the 1970s, can only be expected to continue easing in the foreseeable future. OPEC has been generally unsuccessful in shoring up prices through production cuts. Further, there is every reason to believe that whatever discipline existed within OPEC has effectively disappeared, particularly in light of the fact that some OPEC member countries, such as Nigeria, are in serious straits with regard to their foreign debt situation, and can ill afford production cutbacks that will erode their foreign exchange earnings.

OPEC's predicament is compounded by the recent announcement by Norway and Britain that they would allow market forces to determine the price of North Sea oil. This only implies further easing in the price of this grade of crude which competes directly with Nigerian oil. Another ominous note, as far as OPEC's ability to control world oil prices is concerned, is the recent pronouncement by the head of the Mexican oil agency. In the past, Mexico, while not an OPEC member, has been sympathetic to the organization. However, Mexico now feels that if OPEC cannot discipline its own members regarding production quotas, there is no reason for it to continue to go tacitly along with OPEC goals—the obvious implication being that Mexico may be planning to increase oil production.

Even the weather has, once again, refused to come to the aid of the oil producing nations. The severe winter buffeting the Northern Hemisphere may be too little, too late, as far as increased oil demand is concerned. As a result, any safe bet on the course of oil prices during the next two years should reasonably be on the downside. This month's forecast assumes that the price of imported crude oil will fall to about $25 a barrel by this summer and remain in that vicinity through 1986. This is not as drastic an assumption as it might appear at first glance, since the differential between the average official price and the spot market price of OPEC oil has averaged $1 per barrel since early October. As of the 21st of December, the spot market price for a barrel of OPEC oil stood at $26.77, and had strengthened to only $27.06 by the week of January 11th, in spite of the severity of the winter weather (see Chart 6).

CHART 6
Official Vs. Spot Market Price
For OPEC Oil
($/barrel)



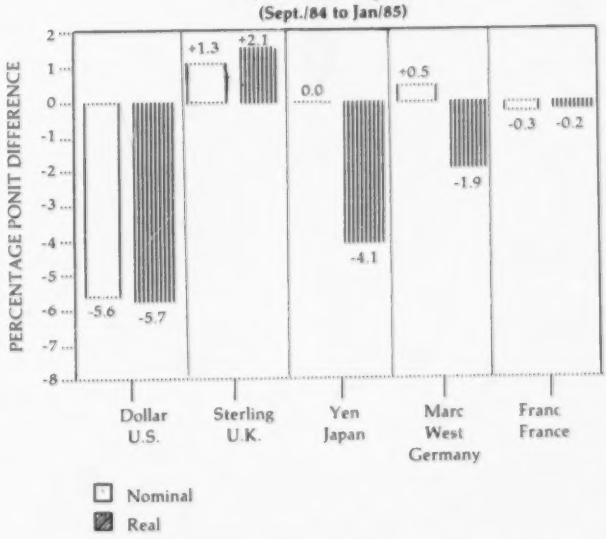
The only negative on the inflation front stems from the impact of a possible decline in the value of the dollar, which we are assuming will take place. As a general rule of thumb, a ten percent decline in the dollar's value is associated with a one percentage point increase in consumer prices (other things being equal), as imported goods become more expensive. Our forecast foresees a rate of increase in consumer prices of 3.3 percent in 1985 and 3.6 percent in 1986, the rise being explained by a partial adjustment in the dollar's exchange rate, but tempered by falling commodity prices, particularly oil.

Exports, Imports and the U.S. Dollar

The refusal of the dollar to decline in value in the face of the yawning U.S. trade gap has stumped analysts who have been predicting such a decline for the past three years. In hindsight, it is easy to see why the American dollar remains in strong demand even though, from a trade point of view, the excess of imports (supply of dollars) over exports (demand for dollars) should have placed downward pressure on the dollar's value. In the past, part of the explanation stemmed from the interest rate differential between the dollar and other international currencies; the higher return of dollar-denominated assets prompted investors to demand more dollars, raising its price. The sharper decline in U.S. inflation *vis-a-vis* foreign rates of inflation also raised the real interest rate differential.

However, the dollar remained strong, even as U.S. interest rates fell and foreign interest rates rose. Between early September and mid-January, the three month Eurodollar rate fell by 556 basis points. By way of comparison, the Canadian Eurodollar rate fell by 253 basis points and the Eurofranc rate eased by just 28 basis points. All other major Eurocurrency rates actually rose, with the Eurosterling rate rising by 132 basis points. Adjusting the Eurocurrency rates for changes in inflation yields the same results in terms of likely pressures on the dollar. The decline in the real Eurodollar rate during this period was 566 basis points. With the exception of the real Eurosterling rate, which *rose* by 212 basis points, all other rates fell significantly less than the real Eurodollar rate (see Chart 7). However, during this same period, far from easing, the trade weighted exchange value of the U.S. dollar rose by 7.5 percent.

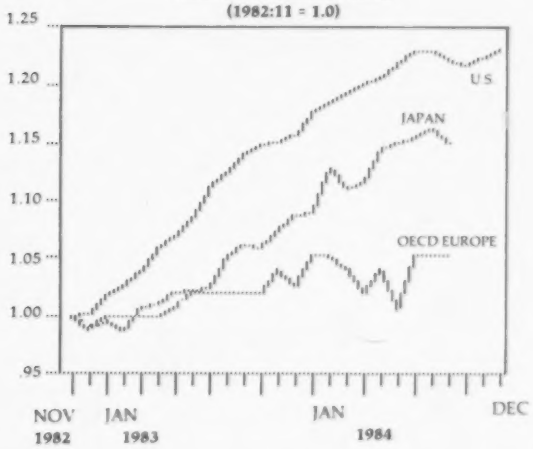
CHART 7
Movements In Selected Eurocurrency Rates
On 3-Month Deposits
(Sept./84 to Jan/85)



At first glance, this kind of movement in the value of the dollar appears to be perverse. Nevertheless, it is explained by the current strength of the U.S. economy and the investment opportunities it creates relative to other industrialized economies. Chart 8 compares the trend in industrial production in the United States with

the performance of Japan and the European members of the Organization for Economic Cooperation and Development (OECD), since the end of the recession. The chart shows, quite dramatically, the continued stagnation of the Western European nations, in spite of the fact that real GNP has recovered. These low rates of industrial production help explain why European unemployment rates remain high, and in some countries, such as France and the United Kingdom, actually rose during the past year. In turn, this is reflected in the low level of consumer optimism in the West European nations. The recent Gallup survey noted that 34 percent of the British, 25 percent of the German and only 15 percent of the French citizens queried thought that 1985 would be a better year than 1984. This compares to 61 percent for the American consumer.

CHART 8
Recovery Experience:
Industrial Production Index
(1982:11 = 1.0)



It must also be pointed out that, in spite of the problems that remain in the American economy, the U.S. recovery has been a major factor in the worldwide recovery now underway. Data released by the Federal Reserve Bank of St. Louis in October of last year show that each of the major trading partners of the U.S., with the exception of France and the United Kingdom, have shown a substantial turnaround in real GNP which was associated with a similar turnaround in their exports to the U.S. In fact, the data indicate that this stimulation of exports is more closely related to the U.S. recovery than to the appreciation of the dollar.

Although the outlook is one of continued growth in Western Europe and Japan, the anticipated future path of economic activity in the United States is significantly stronger. As a result, foreign investors see the U.S. economy as the one offering the most attractive investment opportunities and continue to demand dollars. This situation is likely to persist as long as the United States economy continues to outperform that of its major trading partners. While this is likely to be the case, the growth gap can be expected to be reduced as industrial production strengthens in Western Europe and Japan. Such an outcome, together with a continued decline in U.S. interest rates, can be expected to place downward pressure on the dollar. Any decline in the dollar's value, however, can only be expected to be gradual, particularly given our forecast of a continued positive business environment in this country.

The plight of U.S. export industries resulting from the loss of competitiveness in foreign markets due to the high value of the dollar has been well documented. However, it needs to be emphasized that U.S. exports have not suffered during this recovery. In fact real exports have risen by seven percent since the end of the recession. The surge in real imports, however, has been significantly stronger than average.

While a decline in the dollar's value can be expected to foster a rise in export growth, and in fact, it is just such an increase that we foresee for 1986, the improvement in the trade balance cannot be expected to be immediate. The initial effect is likely to be negative as price effects offset volume effects. The impact on inflation, on the other hand, is likely to feed through rather promptly.

Nevertheless, the source of the anticipated increase in demand for U.S. exports is not only the expected decline in the dollar's value, nor is it the strengthening of the European recovery alone. Western Europe is no longer the largest market for U.S. exports; the Asian countries edged Europe out of its prominent position in 1981. The recovery in the Asian economies, particularly the Pacific Basin nations, has been quite strong, and prospects are for a continuation of that trend. While the Latin American nations have been burdened by massive foreign debt service obligations, two developments, namely, the fall in U.S. interest rates, and the decline in the world price of oil, substantially improve the outlook for these nations which have accounted for as much as 40 percent of U.S. exports to developing countries.

Conclusion

Given our assumption of no further sharp declines in the growth rate of the money supply and no new tax increases, the U.S. economy can look forward to two more years of stable, strong, noninflationary growth. However, as we saw during the third quarter of last year, volatility in the growth of the money supply can have a depressing effect on overall economic activity. The monetary authorities should strive to maintain a stable growth rate in the money supply to minimize uncertainty in the financial markets.

UNITED STATES ECONOMIC OUTLOOK 1983-1986
Prepared by the U.S. Chamber of Commerce

Percent change from previous period at seasonally adjusted annual rates unless otherwise noted.

	QUARTERS								YEARS			
	Actual		Forecast						Actual		Forecast	
	84:3	84:4	85:1	85:2	85:3	85:4	86:1	86:2	1983	1984	1985	1986
GROSS NATIONAL PRODUCT												
Real GNP	1.6	3.9	5.1	5.3	5.1	5.4	4.8	5.1	3.7	6.8	4.6	5.1
Consumption	0.7	3.9	4.1	4.6	4.2	4.1	3.7	4.0	4.8	5.3	4.0	4.0
Residential Investment	-4.5	-2.0	0.6	14.1	23.6	20.8	17.3	9.2	41.7	12.4	5.9	13.9
Business Fixed Investment	13.7	11.1	12.5	12.0	12.1	12.9	14.3	14.1	2.5	20.0	12.8	13.4
Equipment	18.6	8.4	14.6	12.9	12.2	12.6	14.9	14.3	7.3	21.7	13.5	13.6
Structures	2.0	18.4	7.3	9.6	12.0	13.6	12.8	13.7	-7.8	15.7	10.9	12.7
Exports	7.7	-3.2	3.0	9.4	7.1	9.0	9.9	9.4	-5.6	4.6	4.2	9.2
Imports	55.4	-26.6	9.7	8.7	8.6	8.2	8.1	8.1	7.6	27.1	5.6	8.1
Government Purchases	5.4	6.6	2.3	4.1	3.1	0.2	0.5	0.4	-0.3	3.5	4.7	0.9
Inventory Change ($ B)	72	31	40	37	35	40	38	39	-13.5	57	38	39
New Car Sales (mil. units)	10.3	10.2	10.8	11.0	11.1	11.3	11.3	11.4	9.2	10.4	11.1	11.5
Housing Starts (mil. units)	1.7	1.6	1.7	1.8	1.9	1.9	2.0	2.0	1.7	1.8	1.8	2.0
EMPLOYMENT, WAGES AND PRICES												
Unemployment Rate (%)	7.5	7.2	7.0	6.9	6.7	6.5	6.4	6.3	9.6	7.5	6.8	6.2
Compensation	3.6	3.3	5.5	5.0	5.0	5.7	7.0	6.3	4.8	4.1	4.6	6.2
Productivity	-0.7	1.1	3.0	3.6	4.1	3.4	2.8	2.7	3.4	2.7	2.6	3.1
Unit Labor Costs	4.6	1.9	2.4	1.3	0.9	2.2	4.1	3.5	1.3	1.4	1.9	3.0
Consumer Prices	3.6	3.9	3.2	2.6	2.9	3.2	3.6	3.7	3.2	4.2	3.3	3.4
GNP Deflator	4.0	2.4	4.2	3.0	2.7	3.5	3.7	3.8	3.8	3.7	3.3	3.5
Prime Interest Rate (%)	13.0	11.8	9.9	9.7	9.5	9.5	9.3	9.0	10.8	12.0	9.7	8.7
Profits from Current Production ($ B)*	199.8	203.7	213.3	227.4	235.6	240.9	238.8	242.6	149.4	195.9	229.3	243.0
GOVERNMENT FISCAL POLICY ($BILLION)**												
Unified Budget—Receipts									601	666	745	810
Unified Budget—Outlays									796	842	945	990
Unified Budget—Federal									-195	-175	-200	-180

*Corporate profits after tax with inventory valuation and capital consumption adjustments.
**Unified Budget figures on a fiscal year basis.

Source: Modeling and assumptions by U.S. Chamber of Commerce, Forecast Center using the DRI macro model of the U.S. economy.

FORECAST ASSUMPTIONS

This month's forecast contains the Commerce Department's revised estimates of the national income and product accounts for the third quarter of 1984, and the preliminary estimate for the fourth quarter of 1984. It continues to take into account all the provisions of previously enacted legislation, including indexation of personal income tax rates and the Tax Reform Act of 1984. Congress is assumed to pass a deficit reduction package which results in a static reduction in federal government outlays of $17 billion in calendar year 1986. As a result, the Federal Reserve is expected to be slightly more accommodative than would otherwise have been the case; M(1) is allowed to grow by 6.7% in 1985 and 1986, still within its target range. Continued weakness in crude oil spot prices is expected to contribute to a cut in the OPEC marker price from $29 per barrel at present to $25 per barrel by mid-1985. The federal minimum wage is assumed to remain at $3.35 an hour throughout the forecast interval. Sustained growth in foreign markets and falling U.S. interest rates are expected to foster a partial exchange rate correction. The trade-weighted average exchange rate falls by 0.6% in 1985 and 8% in 1986.

Similarly, fiscal policy should address runaway federal spending to free resources and reduce the proportion of GNP that goes to the public sector. Further, strong growth in business investment requires an environment of relative certainty with regard to tax policy. The consideration of tax reform proposals which shift the burden of taxation from consumers to producers (see the article that follows for a discussion of these proposals), engenders uncertainty and thwarts business plans.

THE U.S. TAX SYSTEM: THE TIME IS NOW FOR POSITIVE REFORMS

by
David R. Burton and Graciela Testa-Ortiz*

The tax reform debate has moved to the top of the political agenda. The Treasury Department has released its long-awaited tax reform proposal, a plethora of tax bills have been introduced for consideration by the Congress, and virtually every trade association and political group is organizing to influence the upcoming tax fight.

Throughout the debate, however, we should not forget that the goal of tax reform should be to enhance economic growth. Reduced marginal tax rates and capital cost recovery allowances that reduce or eliminate the tax bias against savings and investment will increase economic growth. Increased economic growth, in turn, will increase employment, raise tax revenues, reduce federal expenditures and help solve the deficit problem. Not just any tax reform proposal, however, will increase growth. As it stands, our tax structure fails to meet this goal. The complexity of the U.S. tax structure, the costs of compliance and administration, and the tax burden on the average taxpayer have grown markedly over the past four decades. The tax system includes hundreds of statutory provisions and myriad rulings, revenue procedures, and regulations. Estimates of the costs of compliance to individuals and businesses and administration by the government reach $60 billion per year. But most importantly, the marginal tax rate for the median income taxpayer has reached 25 percent compared to less than nine percent in 1947. This increase in the tax burden occurred in spite of the tax reduction embodied in the Economic Recovery Tax Act of 1981 (ERTA). ERTA's tax reduction has been erased by inflation-caused bracket creep and post-ERTA tax increases.

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The steady increase in the tax burden has discouraged work effort and encouraged the underreporting of income. The system is biased against savings since it rewards consumption and encourages debt while penalizing savings through the taxation of capital gains, dividends, and interest on savings. This bias is, in part, responsible for the low U.S. savings rate relative to other industrialized nations. Finally, the proliferation of special exemptions and deductions has significantly narrowed the tax base.

ERTA WAS A FIRST STEP IN THE RIGHT DIRECTION

The virtues of lower tax rates and liberalized, more neutral, capital recovery allowances were nicely demonstrated by the economy's response to ERTA. That act created the Accelerated Cost Recovery System (ACRS), which, combined with the investment tax credit, constituted an important step towards a tax system that encourages savings and investment. ERTA also reduced individual tax rates by 25 percent across the board, making it more attractive to work, save, and invest. The combination of incentives provided under the 1981 tax act were the major contributor to the strength of the current expansion. In fact, investment thus far has increased twice as fast as during similar periods in past recoveries. Moreover, the wealthy increased their economic activity so much in response to the reduction in the top marginal tax rate, that they are both paying more taxes and paying a larger share of the total tax burden.

Another ERTA innovation, effective this January, is tax indexing. Tax indexing will prevent inflation from gradually pushing all taxpayers into higher tax brackets, thus ending the hidden, inflation-caused, tax increases which represented a significant drag on economic growth and progress.

Unfortunately, tax legislation since 1981 has been a major step backwards from the reforms achieved under ERTA. The Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA) and the latest Tax Reform Act of 1984 reduced the value of ACRS and increased other taxes by almost $50 billion annually. In fact, according to the U.S. Treasury Department, these two bills, bracket creep, Social Security payroll tax increases, and gasoline tax increases combined to eliminate the entire ERTA tax cut, save $1.2 billion annually.

RECENT TAX REFORM PROPOSALS

The many tax reform bills now under consideration lower tax rates and broaden the tax base by eliminating deductions, credits, and exclusions from the tax code. Looking past that broad similarity, however, they differ substantially. Some retain a very progressive rate

structure while others have a single flat rate. Some accentuate the tax bias against savings and investment while others reduce it. Some create new administrative problems and cost. Other, less important, differences also exist.

Most proposals, though not all, are considered to be revenue neutral in static terms. This means that the proposals can be expected to raise the same tax revenues as the present system if the following assumptions hold. First, that the changes in the tax code have no effect on overall economic growth, and second, that taxpayers' behavior does not change in response to tax code changes. These accounting-like revenue estimates are taken very seriously in Washington, even though they rest on the absurd premise that the tax law does not affect economic decision-making, and hence, economic activity. More realistic dynamic revenue estimates, which try to account for changes in individuals' actual behavior, are derided as inexact. Exact inaccuracy, of course, is of little value.

The Fair and FAST Plans

The two most prominent tax reform bills being considered are the "Fair Tax" introduced by Senator Bradley and Representative Gephardt, and the "Fair and Simple Tax (FAST)" plan introduced by Representative Kemp and Senator Kasten. In many respects, the bills are similar. Of the two, however, the Kemp-Kasten proposal would have much more positive economic effects and taxes families in a more advantageous manner.

Although both bills dramatically reduce individual tax rates and increase the personal exemption, the Kemp-Kasten bill has both lower rates and a larger personal exemption. Further, FAST doubles the dependent allowance and maintains tax indexing while the Bradley-Gephardt bill keeps the dependent allowance at $1,000 and repeals indexing.

On the corporate side, both bills reduce the corporate tax rate but also eliminate the investment tax credit, and repeal the 1981 reduction in the capital gains tax rate as well as scores of other deductions, exclusions, and credits. FAST, however, phases in repeal and indexes the capital basis. The Kemp-Kasten bill retains ACRS, while Bradley-Gephardt replaces it with a substantially less adequate depreciation system. In short, in each important area of difference, Kemp-Kasten is superior to Bradley-Gephardt, and more adequately fulfills the requisites for an optimal tax system.

In spite of the fact that both bills reduce the corporate tax rate, other provisions would have the net effect of raising the cost of capital, as a result, fixed investment would suffer. Because the investment tax credit favors investment in producers' durable equipment, its elimination could result in a shift in the investment mix away from equipment and in favor of investment in nonresidential structures. Although FAST's treatment of investment is more constructive than Bradley-Gephardt's, the scaled back capital cost recovery allowances and higher capital gains tax in both bills can be expected to hinder capital formation and reduce productivity.

The repeal of indexing under Bradley-Gephardt means that lower tax rates, for many Americans, would be only temporary, gradually disappearing as inflation pushed them into higher tax brackets. As a result, incentives to save and invest can be expected to suffer under this proposal. The reduced rate at which mortgage interest is deductible in both bills will hurt the housing market. Since the tax subsidy of housing is capitalized into existing home prices, home values can be expected to decline and limit both the demand for and supply of new homes. Demand will fall due to the wealth effect from the loss of homeowner equity and the increased net-of-tax cost. More than half of the new and existing home demand comes from existing home owners "trading up" to larger houses. All current owners will take a capital loss, limiting their ability to stretch for a larger and more expensive home. Lower prices for existing, and consequently, new homes, will squeeze builders' profit margins, reducing supply.

The nondeductibility of interest paid on debt can be expected to result in reduced credit demands and lower interest rates. This, in turn, should reduce the interest payment on the federal debt and, thus, the federal deficit, further reducing credit demands. Lower interest rates and the reduction in the corporate tax rate may offset a significant portion of the deleterious effect of other tax increases on businesses. While the foregoing analysis of the likely impact of lower interest rates resulting from these proposals follows conventional notions, there is evidence to suggest that the expected stimulus to investment from lower rates of interest may not be forthcoming.

The determinants of the rate of return of an additional dollar of investment include, not only the real rate of interest, but also technology, and taxes. In a recent paper, Robbins, Robbins and Roberts have shown that the most important component of the service price for nonresidential corporate investment is technology, which affects the relative productivity of alternative investments (See Robbins, A.E., Robbins, G.A., and Roberts, P.C., *Supply Side Economics and the Cost of Capital*). The second most important determinant, according to their calculations, is taxation, including property, sales and income taxes. The current tax

structure increases the service price of capital by 30 percent for investments in both equipment and structures. On the other hand, the elasticity of the service price of capital with respect to the after-tax interest rate is only 0.11, implying that a ten percent decrease in the real after-tax interest rate will increase the service price of capital by only 1.1 percent.

This explanation sheds some light on the recent performance of the investment sector. In general, the forecasting community failed to foresee the strength of nonresidential investment during this recovery because real interest rates were deemed too high to support high levels of investment. As a result, the record-breaking strength of the nonresidential sector surprised almost everyone. However, recall that ERTA sharply reduced the cost of capital. The positive impact of lower tax burdens, together wih the rapid advances in technology now underway, served to offset the negative impact of high real interest rates yielding the capital boom that we are currently experiencing.

The Treasury Proposal

The Treasury Department's tax reform proposal is disappointing because it reverses many of the wise policies enacted in 1981. It also shifts the tax burden away from consumers towards producers. While individual, estate and gift, and excise tax receipts would be reduced over the 1986-1990 period, corporate taxes, under this proposal, more than offset this decline, rising an astonishing $165 billion. The proposal would eliminate the capital gains exclusion, the investment tax credit and ACRS. The capital cost recovery system that would result from this plan is the worst since the Great Depression. Buildings would be depreciated over 63 years and equipment over 12 to 25 years. Furthermore its corporate tax rate reduction, from 46 percent to 33 percent, compares poorly to other reform proposals. Business taxes would increase by 25 percent in 1986 and 36 percent by 1990. Small businesses would be particularly hurt by burdensome new administrative requirements in the fringe benefit and depreciation areas. Capital basis indexing and partial dividend relief are two of the few positive aspects of the plan.

On the individual side, the maximum tax rate would be reduced to 35 percent and many deductions, credits, and exclusions would be repealed. This, however, is the highest tax rate of any major reform proposal. The tax treatment of savings and investment under the plan is less neutral than present law and most reform proposals (including Bradley-Gephardt), now under consideration. However, some positive provisions are incorporated into the Treasury plan, including increased annual IRA deduction amounts, and doubled personal and dependent exemptions.

Compared to current law, the Treasury tax plan can be expected to result in a falloff in fixed investment but slightly stronger consumer spending. Both personal consumer spending and savings would rise as a result of the reduction in individual income tax rates which contribute to increased after-tax income. Personal savings would also benefit from the increase in the IRA limit. Higher after-tax wages would raise the supply of labor placing downward pressure on wages and reducing labor costs. At the same time, however, the repeal of the investment tax credit and ACRS would raise the cost of capital. Consequently, the capital-labor ratio will decline. The combination of reduced capital formation and a lower ratio of capital to labor can be expected to reduce output per manhour and, thus, diminish the economy's future growth prospects.

Even with tax rates reduced from 46 to 33 percent, with dividend payouts inceased to 50 percent, with high rates of inflation and relatively low real discount rates, the Treasury proposal would dramatically raise the user cost of capital. Using Treasury's assumptions of five percent inflation and four percent real interest rates, investors in ACRS three-year property would experience a three to four percent increase in their capital costs. Similarly, investors in ACRS five-year property, representative of most equipment, would see their costs increase by nine to 12 percent. The capital costs for structures would decrease 11 percent. Higher real interest rates (such as those we are currently experiencing) would cause all of these capital costs to increase and result in higher capital costs for structures than at present.

Only adequate capital cost recovery allowances allow the economy to grow as quickly as would be possible under an unfettered free market. Exacerbating the tax bias against investment, as the present Treasury proposal does, constitutes a reversal of the pro-growth policies inaugurated in 1981. It is clear that the anti-growth aspects of the plan's dramatic increase in capital costs will swamp its moderate pro-growth aspects, such as reduced tax rates on labor income.

As with the FAST and Fair proposals, the reduced deductibility of interest payments can be expected to diminish credit demands and interest rates. Reduced wage pressures can be anticipated to result in lower prices. Over the longer run, the combination of lower interest rates and lower inflation may help improve the investment environment; however, the nation's capital stock will be left at a lower level than would otherwise have been the case. As with the Fair and FAST plans, however, it is not clear that the resulting decline in nominal interest rates will spur investment sufficiently to offset the negative impact of higher tax burdens on capital. The impact on the housing market should be similar to that of the Fair and FAST plans.

Other Tax Reform Proposals

Senator Roth and Representative Moore have introduced the Broad-Based Enhanced Savings Tax Act (BEST). This bill, in contrast to the Fair Tax and FAST would be unambiguously good for the economy because it both lowers rates and has a more neutral tax base. The bill eliminates the discrimination against capital expenses. It allows plant and equipment to be deducted in the year incurred just like any other expense. Real property, however, is not expensed. The bill creates a super-savings account, similar to an Individual Retirement Account (IRA). Taxpayers could deduct up to $20,000 in savings and would pay tax, but no penalties, for withdrawals. The bill lowers the top individual rate to 34 percent by 1990. This bill, which can best be described as a step towards a consumed income tax, deserves very serious consideration as an alternative to tax reform bills which lower tax rates by increasing the tax bias against savings and investment. The bill does not, however, address the corporate tax.

Representative Heftel's "Cash Flow Income Tax" is a fairly pure consumed income tax. It eliminates the discrimination against capital assets by expensing all investment. All savings are deductible but taxable upon withdrawal. Furthermore, the double taxation of corporate income is dramatically reduced, although not eliminated, by the bill's deduction for both cash and stock dividends. Except for an individual's first $20,000, all loans are included in the tax base while principal and interest payments are deductible. The current preferred status of primary residences is retained. The top rate, on income above the Social Security wage base, is 30 percent. Representative Heftel's proposal has the merit of almost entirely eliminating the tax bias against savings. Furthermore, it maintains tax rates as low as most other bills—including those with substantially less attractive tax bases. The bill would have an unambiguous, strong, positive effect on capital formation and, consequently, employment and growth.

Senator DeConcini and Representative Shelby have introduced the 19 percent flat tax plan originally proposed by Robert Hall and Alvin Rabushka in their book *Low Tax, Simple Tax, Flat Tax*. This system appears simple and straight forward, but its apparent simplicity is partly caused by the many questions it leaves unanswered. The proposal expenses capital expenditures. It does not allow businesses to deduct interest payments or costs associated with fringe benefits. Thus, in effect, it has a 19 percent withholding tax on investment, savings, and fringe benefit income. The bill does not tax individuals' savings income. However, many middle income taxpayers would experience tax increases under this plan because literally every personal deduction is eliminated and the 19 percent bracket starts (in the version to be introduced in the next Congress) at $9,000 for joint returns. The dependent allowance is $1,800. The proposal is interesting but needs a great deal of elaboration before it could be enacted.

Representative Siljander and Senator Nickles have introduced a ten percent flat tax. The bill does not address the corporate tax. There is little doubt that this bill would reduce federal tax revenues. Such a dramatic reduction in tax rates, combined with the retention of ACRS, would no doubt spark an unequaled supply-side effect. To the extent that this burst of growth did not expand the tax base enough to keep the federal deficit within reasonable limits, however, the bill may have adverse economic impacts. Based on historical federal and state experience, the tax amnesty proposal in the Siljander-Nickles bill can be expected to raise about $6 billion to $8 billion—a large sum, but not enough to make up all lost revenue. Unless federal spending is reduced enough that revenue shortfalls did not pose a substantial problem, the Siljander-Nickles proposal is a high risk proposition.

CONCLUSION

Tax reform could dramatically increase economic efficiency and spark unequaled economic growth. But all tax reform proposals are not created equal and some are clearly better than others. The wrong kind of tax reform, in particular a tax system which shifts the burden to the corporate sector, as many of them do, could have very serious long run effects on the U.S. economy.

In addition to being simple, efficient, and fair, a constructive tax system must reduce marginal tax rates, *and* reduce the tax bias against savings and investment if it is to have a positive effect on employment and economic growth.

Further, the optimal tax reform package would conform to the following principles. First, tax reform must not become an euphemism for tax increases. Second, any attempts to reduce the federal deficit should concentrate on spending reduction and economic growth, not tax increases. In the previous issues of ECONOMIC OUTLOOK (see the December, 1984 issue) we have shown the extent to which federal spending is out of control and the opportunities available to reduce spending growth. In our analysis of the high growth agenda we have also shown that policies geared toward sustaining a healthy business environment would promote economic growth and reduce the deficit.

Other important principles of tax reform include the following: tax reform should reduce or eliminate the progressiveness of our tax rates; it should retain

indexing so that the government may not surreptitiously profit from inflation; and finally, tax reform should not mislead the public regarding the amount of tax they are actually paying.

GIVING FREE TRADE A BAD NAME

by
Rajni Bonnie Ohri

"Before I built a wall I'd ask to know
What I was walling in or walling out,
And to whom I was like to give offence."

—Robert Frost

Despite the strength of the U.S. business upswing, trade officials are alarmed by the rumblings of a protectionist avalanche that could bury the global economic recovery under the rubble of the trading system. With the U.S. trade deficit mounting towards $120 billion in 1984—double the level of 1983—alarm is understandable. Protectionist pressures are being stoked in the U.S. by the strong dollar, in Europe by stubbornly high unemployment, in developing countries by the need to earn foreign exchange to pay off huge debts, and almost everywhere by industrial and social adjustments being forced by technological change.

International trade is very important to American farmers and manufacturers, and of increasing significance to our service industries. Over twenty percent of our industrial output and 40 percent of our agricultural products are exported. One-third of all corporate profits come from foreign trade and investment. From 1960 to 1983, the ratio of imports to GNP rose from 4.6 percent to 10.4 percent while the share of exports in GNP increased from 5.7 percent to 10.2 percent. One implication of this growing international orientation is the increase in the proportion of the labor force that is affected by international trade. The proportion of manufacturing employment related to exports rose from 8.1 percent in 1970 to 14.5 percent in 1980 while at the same time, the proportion of manufacturing jobs facing import competition rose from 8.4 percent in 1970 to 14.7 percent in 1980. Other productive factors also have an increasing stake in foreign trade. During the same period, the import-related share of manufacturing value added increased from 8.3 percent to 14.4 percent, and the export-related share increased from 8.5 percent to 15.1 percent.

Defending Free Trade

Advocacy of an open trade system—free exchange of goods among countries—has been a part of the foundation of America's international leadership. The arguments in favor of free trade are supported by historical evidence. During the 1930s, the U.S. and many other countries followed "beggar-thy-neighbor" trade policies which contributed to the worldwide depression. The Smoot-Hawley protectionist tariff epitomized this approach in the U.S. Subsequently, U.S. trade policy shifted to the negotiation of reciprocal trade agreements. These tariff reductions were followed by an acceleration in world trade and economic growth. International trade was an engine of growth during the 1960s and 1970s, largely because of the decline in tariffs negotiated through the General Agreement on Tariffs and Trade. World tariffs now average only around 5 to 10 percent of the value of imports, compared to 53 percent in the 1930s.

Free trade is viewed by many experts as best for the economy as a whole. Whether from domestic or foreign sources, competition forces firms to follow lowest cost, highest productivity practices to satisfy consumers at the lowest prices. An open trading system contributes to lowering inflationary pressures by increasing the supply of goods and services competing for the consumer dollar. It also minimizes the role of government in influencing private sector decisions, thus allowing individuals and business firms to respond to the needs of the marketplace. In addition, free trade allows the price mechanism to allocate resources by drawing labor, capital and other factors into their most productive uses. It thereby yields more growth, higher levels of employment, and an improved standard living at home. Society as a whole gains because free trade increases both the quality and quantity of the goods available for consumption.

The Costs of Protectionism

The costs of protectionism are high. They include costs to domestic consumers in terms of higher prices and limited choices; they inflict damage on the heavily indebted foreign nations struggling to increase export earnings; and they incur costs to domestic exporters who might face retaliation. Also at risk are the very groups whom trade restrictions are supposed to protect. Although relief from tough foreign competition may temporarily benefit protected industries and workers, nobody benefits from losses in production and consumption which occur when the protected compa-

nies produce inefficiently and the resulting high prices discourage some buyers. In addition, many of these industries also risk widening the cyclical swings in the demand for their products.

Ultimately, the costs of protectionism are borne by consumers in the form of higher prices. Consumers face a narrower range of goods and higher prices as imports are restricted. Thus, protectionism can be viewed as a hidden tax on the consumer. A recent study by the Center for the Study of American Business estimated that in 1980 this hidden tax came to more than $58 billion, or $255 per American consumer. Another report by the Center showed that voluntary quotas on imports of footwear, which were eliminated by the Reagan administration, acted as a regressive tax that hurt low-income consumers relatively more than those at higher levels.

Robert Crandall of the Brookings Institute estimates that automobile quotas have raised the price of Japanese cars sold in the U.S. by about $900 and bid up the price of domestic cars by nearly $400, implying a consumer cost of nearly $4.5 billion yearly. Martin Wolf of the Trade Policy Research Center in London has placed the cost of textile and apparel tariffs and quotas at about $12 billion annually for U.S. consumers. And statistical estimates by the International Trade Commission show that U.S. consumers paid an extra $700 million annually because of footwear protection in 1977-81. Most studies show that consumer costs far outweigh the adjustment costs in the form of temporary unemployment that might be experienced absent protection.

Other countries have not fared any better. European agricultural policy costs European consumers nearly $20 billion per year. For every $20,000 per year job protected in Swedish shipyards, Swedish taxpayers pay an estimated $50,000 annual subsidy. When Japanese consumers pay eight times the world price for beef, Japanese farmers are not made eight times better off. It costs them that much more to produce it. And, though Swiss wine drinkers pay $50 million more than they would at world prices, Swiss producers have nothing left over for high living.

Protectionist measures are a two-edged sword. They may well reduce imports from abroad, but at the same time they make it more difficult for domestic firms to export their products. From the viewpoint of economic performance, protectionist measures are counterproductive, impoverishing domestic and foreign producers and consumers alike. In addition, they reduce competition. By encouraging capital and labour to stay in less-efficient industries, they also result in lower productivity and output, especially by the domestic industries purchasing the products of the protected companies. All this generates pressures for additional protectionist measures.

Around the world, trade barriers are erected to keep out American products, while imports come into the U.S. in a flood that threatens to swamp our industries (see Table 1). For example, U.S. exporters to Japan encounter not only relatively forthright trade barriers, but also complex wholesale and retail distribution systems and even, a national ethos that discourages the purchase of foreign goods. Japan has restricted imports of textiles, apparel, autos, telecommunications equipment, footwear, finished wood and paper products, leather, and pharmaceuticals from the U.S. But, protectionist measures are not aimed solely at the U.S. The EEC (European Economic Community) has slapped restraints on imports of steel, tape recorders, television sets, machine tools, autos, and ten other important manufactured products from Japan as well as the U.S. Canada has put up barriers to imports of textiles, apparel, steel, autos and both leather and nonleather footwear.

TABLE 1

U.S. IMPORTS AND EXPORTS 1984 VS. 1983
(percent change)

Area	Imports[a]	Exports[b]
Canada	28.8	23.2
20 Latin American Republics	19.1	15.9
Western Europe	32.2	3.2
United Kingdom	15.4	14.5
Federal Republic of Germany	35.0	4.1
Japan	41.8	8.2
Other Asia	27.1	-5.6
TOTAL	27.5%	8.6%

(a) U.S. imports, customs value basis (unadjusted)
(b) U.S. exports, F.A.S. value basis (unadjusted)
Source: U.S. Department of Commerce

New protectionist actions and reactions are loomimg in steel, autos, farm products, and other major trade categories. Since 1980 the U.S. has restricted imports of specialty steels, textiles, apparel, and motorcycles. It has negotiated agreements with the EEC to curb carbon steel exports to the U.S. and with Japan to limit auto sales in the U.S. Developing countries are rapidly becoming the next target for protectionist attack. Since World War II, their need to stimulate and protect their economic development by means of subsidies and import barriers has been tacitly conceded by the industrial nations. Although this indulgence has been

reinforced recently by the developing countries' need to earn foreign exchange to pay their debts, there are signs that such forebearance is wearing thin.

Protectionist Threats on the Rise

U.S. trade critics tend to disregard the free trade arguments and instead, point to the fact that the U.S. is running a deficit in its merchandise trade account (see Table 2). And, in particular they tend to focus their concern on Japan, America's second largest trading partner, after Canada. During the period 1976-83, the U.S. incurred a cumulative trade deficit—primarily as a result of Japanese penetration into U.S. markets for textiles, television sets, automobiles, motorcycles, radios, photographic equipment, video tape recorders, watches, machine tools, and steel—of about $95 billion.

TABLE 2
COMPARISON OF U.S. MERCHANDISE TRADE WITH JAPAN AND WESTERN EUROPE
(billions of dollars)

Area	1976	1977	1978	1979	1980	1981	1982	1983
Japan								
Exports	10.2	10.6	13.0	17.6	20.8	21.8	20.7	21.9
Imports	15.5	18.6	24.5	26.3	31.2	37.6	37.7	41.4
Deficit	-5.3	-8.0	-11.6	-8.6	-10.4	-15.8	-17.0	-19.5
Western Europe								
Exports	31.9	34.1	39.6	54.2	67.6	65.1	59.7	55.9
Imports	23.0	28.2	36.6	41.8	47.3	52.9	52.9	53.8
Surplus	8.9	5.9	2.9	12.4	20.3	12.2	6.8	2.1
Net Surplus (+) or Deficit (-)	+3.5	-2.1	-8.7	+3.7	+9.9	-3.6	-10.2	-17.4

Source: U.S. Department of Commerce

Protectionists argue that U.S.-Japanese trade policies are asymmetric and claim that the Japanese market is closed to U.S. products. The following examples are used to prove their point: product design standards and their administration are intended to restrict the entry of U.S. products into Japanese markets; Japanese importers must cut through unnecessary red tape to obtain permission to import U.S. products; tariffs, particularly on finished wood and paper products, tobacco, refined copper, computer parts, chocolate, and leather, inhibit U.S. exports to Japan; targeted industries, particularly beef, citrus and electronics, are shielded from outside competition by Japan; other targeted industries are awarded special favors by Japan, and this gives them an unfair advantage to penetrate the U.S. market. In addition, direct foreign investment in Japan is difficult because Japan's policies are unclear and foreign investors are not accorded the same treatment as Japanese nationals.

A clear example of the asymmetrical trade relationship between Japan and the U.S. lies in the semiconductor industry. Japan Inc. has successfully leapfrogged over the last generation of semiconductor technology and now controls 56 percent of the U.S. market in advanced computer memories. The Japanese have accomplished this feat by keeping out direct U.S. investment, while insisting that U.S. manufacturers wishing to sell in the Japanese market share their technology with Japan. Texas Instruments was permitted to set up a joint venture with Sony, but had to limit its market share to ten percent and license its patents to Sony, Hitachi, Toshiba and Mitsubishi.

Given these complaints and the rising protectionist sentiment in the U.S., the administration's reaction has been relatively mild. Voluntary quotas for automobiles were agreed to, and restrictions were placed on various types of steel, motorcycles, and several other products. But to its credit, the Reagan administration has resisted other proposals for protectionist policies that would restrict Japan's ability to trade with the U.S. However, on January 10, the Federal Communications Commission announced that it is considering retaliating against Japanese trade barriers by requiring the same kind of product certification process that Japan uses to keep out U.S. products. The problem remains that the Japanese prefer export restraints to any significant steps to open up their own markets.

Japan is far from alone, however. Over the past few years, South Korea and other advanced developing countries such as Brazil, Mexico, and Taiwan have become formidable new rivals of the industrialized countries, not only in steel, but also in shipbuilding, machine tools, construction, and electronics. In its two way trade with the newly industrialized countries (Taiwan, Singapore, Hong Kong, South Korea, Malaysia, Thailand, Indonesia), the U.S. sells more than it buys in only *one* broad category of goods: food, feeds, and beverages. And, it's not surprising that, in agricultural goods, the U.S. has an edge, in view of the high ratio of population to arable land in the region. But in every other category, the newly industrialized nations come out ahead. These countries not only dominate the consumer goods sector but also run bilateral trade surpluses in industrial supplies, autos and capital goods. While the region's total exports to the U.S. climbed 136.7 percent in the first 8 months of 1984, U.S. exports to the region grew only 5.1 percent, largely due to the various import restrictions the region erects on U.S. products.

A case in point is Korea. Although Korea claims to have removed restrictions on some 83 percent of the products it imports, these restrictions were replaced in almost every case, with tariffs that have a similar

effect. Korea's restrictive import licensing includes such U.S. goods as horticultural products, computers and related equipment, machine tools, consumer goods, and canned fruit products. Foreign cigarettes, in general, are completely banned from Korean markets.

The EEC is also looking towards protectionist measures against U.S. goods to ease a financial crisis brought on by the runaway costs of subsidies to European farmers. Brussels, for example, is expected to impose quotas on imports of livestock feeds, such as corn gluten, worth about $700 million a year to U.S. farmers. The EEC is also considering import duties on vegetable oils, which could drastically cut back $4 billion a year in imports of soybeans from the U.S. U.S. high technology exports and services have also suffered from European protectionism. AT&T has met with difficulty in selling its telecommunication equipment in Europe. Boeing's role as a leading producer of aircraft has also been eroded due to the penetration of the European Airbus into world routes previously dominated by Boeing.

Trade between the U.S. and Canada is the world's most extensive bilateral exchange, amounting to nearly $120 billion in 1984. But, protectionist sentiment is also running high against U.S. products. Canadian tariffs on selected items of U.S. agricultural equipment run as high as 14 percent. Tariffs on certain telecommunications products are significantly higher than U.S. tariffs on Canadian products (17.5 percent versus 8.5 percent). On the whole, by 1987 an estimated 85 percent of Canadian goods to the U.S. will have duty-free access while only 65 percent of U.S. goods to Canada will have the same privilege.

Conclusion

Overall, trade protectionism continued to rise last year as the effects of recession on employment persisted in the world economy and as exchange rates often responded more to developments in the financial sector than to trade flows. While world trade did expand modestly in 1983 in terms of volume—although it contracted in U.S. dollar terms—the ratio of trade volume growth to output growth remained below its long run level, reflecting the persistent dampening effects of rising protectionism in recent years.

The Reagan administration has made some inroads in trying to stem the rise of protectionism. Recently, the administration has been involved in trade talks with France and others aimed at reducing the subsidy element in export financing. These foreign subsidies are threatening U.S. industries such as commercial aircraft, machine tools, computer chips, and electric and nuclear power equipment that were once dominant overseas. In addition, expansion of trade and a reduction of trade barriers between the Soviet Union and the U.S. is being considered by the administration. The main goals of the President's trade policies include formulating rules for international trade in services, improving existing rules for government procurement and subsidies, and seeking common approaches to barter and trade with the Soviet Union, China and other nonmarket economies.

U.S. trade policies must serve to open markets abroad and to promote the competitive adjustment of U.S. industries in international trade, not to insulate the American economy. Clearly, the U.S. must stress access to foreign markets in those countries and in those sectors where the international competitive position of important sectors of the American economy is at stake. The choice now facing the major trading nations is between a further drift to protectionism or a joint effort to remove trade barriers. After all, free trade is a two-way street.

TRENDS IN COMMERCE NOTES ON TABLE II

January/February 1985

by
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Gross National Product (GNP) - The Department of Commerce preliminary estimate for economic activity in the fourth quarter of 1984 indicates that GNP—the value of the nation's output of goods and services—grew at an inflation-adjusted annual rate of 3.9 percent, a significant upward revision from the earlier estimate of 2.8 percent. While the fourth quarter growth rate is a notable slowdown from the the first half of 1984 when GNP was growing at an 8.6 percent annual rate, it is more than double the rate of growth in the third quarter. The 6.8 percent rate of economic growth in 1984 was the best single year performance for the economy since 1951. The 1984 economy exceeded the expected rate of growth for the economy as predicted by 49 out of 51 business economists and forecasting services. Business fixed investment was up 20 percent for all of 1984, the best performance in recent economic history, and grew at an 11.1 percent annual rate in the fourth quarter, the sixth consecutive quarter of double digit investment growth.

Money Supply -The nation's money supply—as measured by M-1, currency in circulation plus demand deposits—increased by 0.9 percent in December. This resulted in a 3.9 percent increase (seasonally adjusted annual rate) in the money supply in the latest three

month period. This performance places the nation's money supply, up 5.5 percent from a year ago, in the target growth range of four percent to eight percent established by the Federal Reserve Board earlier this year. However, it remains below the six percent growth target set by the Federal Open Market Committee at its October 2 meeting.

Employment - Civilian employment—as measured by the monthly survey of households—jumped by 341,000 persons (seasonally adjusted), in December to 106.3 million, bringing the employment increase for 1984 to 3.2 million. The establishment data indicated that American businesses hired one million new workers in the last three months of 1984. The U.S. economy has created 7.3 million new jobs since the end of the recession in November 1982. Despite very rapid job growth, the civilian unemployment rate inched up in December by 0.1 percentage points to 7.2 percent.

Prices - The Consumer Price Index for all urban consumers (CPI-U) rose 0.2 percent in December, following a 0.2 percent increase in November. The December data reflects declines in gasoline and apparel prices. For the 12 months ended in December 1984, the CPI advanced 4.0 percent. This compares favorably with calendar year increases of 3.9 percent in 1982 and 3.8 percent in 1983. It also shows continued moderation of price increases despite rapid economic growth.

Wholesale prices of finished goods edged up 0.1 percent in December following a 0.5 percent increase in November. This was only the second increase in the last five months for this index which is composed solely of goods, and does not include services which are a part of the consumer price index. The wholesale price index for finished goods is now only 0.6 percent higher than it was six months ago, and only 1.8 percent higher than its year ago level. The December slowdown in the rate of increase for finished goods was due to a decline in energy prices and an across the board slowdown in most finished goods prices.

The more volatile part of the Producer Price Index, crude goods, declined 0.4 percent in December. Crude materials prices were 1.3 percent below their levels of a year ago this December.

Housing Starts - Privately-owned housing units were started at an annual rate of 1,587,000 in December, up 2.1 percent from November. The gain was the result of a jump in single family home construction that more than offset a loss in apartment building starts. This was the second consecutive monthly gain for housing starts. For 1984 as a whole there were 1,744,000 new housing units started, two percent more than in 1983 and the best performance for housing starts since 1979. Starts peaked early in the year at an annual rate of over two million units and then slowed significantly in the summer months, but made a comeback after interest rates started falling in the fourth quarter. Building permits in December were virtually unchanged from November averaging 1,588,000. This was a significant increase from September and October when permits fell to their lowest levels of the recovery.

Industrial Production - Industrial production increased 0.6 percent in December, the largest increase in five months. This followed a 0.4 percent increase in November which was preceded by declines in September and October. Increases in production occurred in all major groupings of the index. Fourth quarter industrial output was about the same as in the third quarter. However, industrial production in December was 6.4 percent higher than a year ago. Business equipment production rose 0.7 percent, following no gain in November. This placed business equipment production at 12.7 percent above the level of a year ago, double the increase in production for the entire index. U.S.mine production increased one percent in December, the largest increase for any market grouping. Consumer goods production rose by 0.6 percent in December, largely due to a 0.8 percent increase in durable goods as automobile production continued to rebound.

The capacity utilization rate for manufacturing, mining, and utilities moved up 0.3 percentage points in December to 81.9 percent. This was below the level of mid-1984 due to an increase in capacity. Capacity in the fourth quarter continued to increase as American industry added 0.6 percent to its output capability. This was 2.6 percent above a year ago. For 1984 as a whole the capacity utilization rate was 81.6 percent, the highest since 1979, yet still below the 1967-82 average of 82.4 percent.

Business Costs and Productivity - Private business sector productivity, as measured by output per man-hour of all people, increased at a 2.7 percent annual rate in 1983. Productivity continued its climb in the first half of the year as output per hour rose at a 4.5 percent average annual rate, but slowed to a 0.9 percent annual rate in the third quarter. In the nonfarm business sector productivity fell at a 0.7 percent annual rate. Manufacturing productivity increased at an eight percent annual rate, indicating a quick pay off on new equipment purchases. Third quarter unit labor costs were up 1.6 percent over their year-ago level, but below their first quarter rate. Unit labor costs were held down by the increase in productivity which offset increased costs for employee compensation.

TABLE II
TRENDS IN COMMERCE

	Current Period		Previous Period	Year Ago	Percent Change From Previous Period	Percent Change From Year Ago
Population (Millions)	Nov/84	237.6	237.5	235.5	0.1	0.9
Gross National Product ($B) [a]	IV/84	3,752.5	3,694.6	3,431.7	1.6	9.3
Gross National Product (72$B) [a]	IV/84	1,661.1	1,645.2	1,572.7	1.0	5.6
Money Supply (M1) [a]	Dec/84	554.3	549.4	525.4	0.9	5.5
PEOPLE AND THEIR MONEY						
Personal Consumption Expenditures ($B) [a]	Dec/84	2,424.9	2,396.9	2,245.9	1.2	8.0
Personal Consumption Expenditures (72$B) [a]	Nov/84	1,074.7	1,065.1	1,031.3	0.9	4.2
Disposable Personal Income ($B) [a]	Dec/84	2,661.2	2,650.8	2,448.7	0.4	8.7
Disposable Personal Income (72$) [a]	Nov/84	1,188.6	1,182.7	1,123,3	0.5	5.8
Personal Savings Rate (%)	Nov/84	6.3	6.4	5.3	-0.1[b]	1.0[b]
Civilian Employment (millions) [a]	Dec/84	106.3	105.9	103.0	0.3	3.1
Civilian Unemployment Rate (%) [a]	Dec/84	7.2	7.1	8.2	0.1[b]	-1.0[b]
Average Hourly Earnings ($) [a]	Dec/84	$8.48	$8.42	$8.17	0.7	3.8
Consumer Price Index (All Urban, 67=100)	Dec/84	315.5	315.3	303.4	0.2	4.0
Purchasing Power of the Dollar	Dec/84	0.313	0.313	0.333	0.0	-6.3
Prime Interest Rate (%) January 25, 1985	Jan/85	10.5	11.25	11.0	-0.75[b]	0.5[b]
Retail Sales ($) [a]	Dec/84	110.8	110.9	102.4	-0.1	8.2
BUSINESS PROFITS AND OUTPUT						
Nonfinancial Corporate Profits ($B)						
Before Tax	III/84	224.8	246.0	227.4	-8.6	-1.1
After Tax	III/84	141.7	150.2	142.6	-5.7	-0.6
Industrial Production (67=100) [a]	Dec/84	166.2	165.2	156.2	0.6	6.4
Capacity Utilization Rate (Mfg.) (%) [a]	Dec/84	82.2	81.9	79.0	0.3[b]	3.2[b]
New Housing Starts (thou. units) [a]	Dec/84	1,587.0	1,554.0	1,694.0	2.1	-6.3
Net Business Formation (67=100)	Nov/84	120.6	119.9	117.8	0.6	2.4
New Business Incorporations (Thousands) [a]	Jun/84	54.7	51.2	51.0	6.8	7.3
BUSINESS COST						
Unit Labor Costs (nonfarm) (77=100) [a]	III/84	159.4	157.6	155.9	1.1	2.2
Unit Nonlabor Costs (77=100) [a]	III/84	154.4	152.3	150.9	1.4	2.3
Producer Price Indices (67=100)						
Crude Materials [a]	Dec/84	329.0	330.4	333.6	-0.4	-1.3
Intermediate Goods [a]	Dec/84	321.1	321.6	317.1	-0.2	1.3
Finished Goods [a]	Dec/84	292.6	292.4	287.4	0.1	1.8
FEDERAL SPENDING AND DEBT						
Federal Spending Index (67=100) [a]	Dec/84	605.5	579.7	532.0	4.4	13.8
Fed. Gov't Debt Outstanding ($B)	Sep/84	1,576.7	1,565.1	1,381.9	0.7	14.1
INTERNATIONAL TRADE						
Exports of Goods & Services ($B) [a]	IV/84	364.7	368.6	346.1	-1.1	5.4
Imports of Goods & Services ($B) [a]	IV/84	429.0	459.3	375.9	-6.6	14.1
Balance on Goods & Services ($B) [a]	IV/84	-64.3	-90.7	-29.8	-29.1	115.8
WHAT'S AHEAD?						
Index of Leading Indicators (67=100)	Nov/84	166.6	164.5	162.5	1.3	2.5

NOTES: [a] Seasonally adjusted data
[b] Percentage point difference

Interest Rates - The prime rate, after remaining at 13 percent since June, fell to 12 percent in October. It continued to decline in December and now stands at 10.5 percent. Both short-term and long-term interest rates have declined sharply since mid-year. The federal funds rate, which was 11.47 percent in the week ending June 22, fell by 272 basis points, averaging 8.75 percent by January 4. At the same time Triple-A corporate bonds fell by 150 basis points, averaging 12.2 percent on the week of January 4th.

Business Failures and Formations - Dun and Bradstreet's Index of Business Failures for January indicates that failures were significantly below the levels of a year ago. The business discontinuance index, however, was higher than it was a year ago resulting in about the same rate of business closures for the month of December 1984 as in December 1983. The latest available data indicates that there were 269,984 new business incorporations in the first five months of 1984, a 9.9 percent increase over the same five month period in 1983. The largest percentage increases in the first five months of 1984 were reported in the following areas: Georgia, 32.1 percent; Washington, D.C., 31.9 percent; North Dakota, 30.7 percent; Maryland, 28.1 percent; and Virginia, 27 percent. Regionally, the largest percentage increase was reported in New England where new incorporations were up 17.2 percent.

Federal Spending - The "Federal Spending Index," a U.S. Chamber devised measure of the monthly change in federal expenditures, indicates that federal spending increased 4.4 percent in December. Receipts for the month were up 7.2 percent from the same month a year ago due to large increases in personal income and social insurance taxes. Federal receipts for the first quarter of fiscal 1985 increased 11.2 percent from the same three months in fiscal 1984, but expenditures rose 12.2 percent resulting in a $9.1 billion increase in the federal deficit. The 12.2 percent increase in outlays is nearly three times the rate of inflation for the period. This indicates that efforts to control the federal deficit must be centered on expenditure control, since expenditures are increasing significantly faster than prices.

Personal Savings - According to Department of Commerce data, personal savings rose to 6.3 percent of after-tax income in the fourth quarter. Personal savings in 1984 were nearly $39 billion higher than they were in 1983, with the percentage of income saved increasing from five percent in 1983 to 6.1 percent in 1984. This means that one out of every six dollars in increased income in 1984 went into savings.

Retail Sales - Retail sales decreased 0.1 percent in December, following an increase of two percent in November. The December outcome stemmed from declines in gasoline prices and automobile sales for the month. The traditional areas of Christmas shopping—department stores, clothing stores and restaurants—all experienced double digit gains compared to last Christmas. December retail sales were 8.2 percent above year-ago level. This indicates that, after taking into account inflation, retailers sold about five percent more merchandise this Christmas than in 1983.

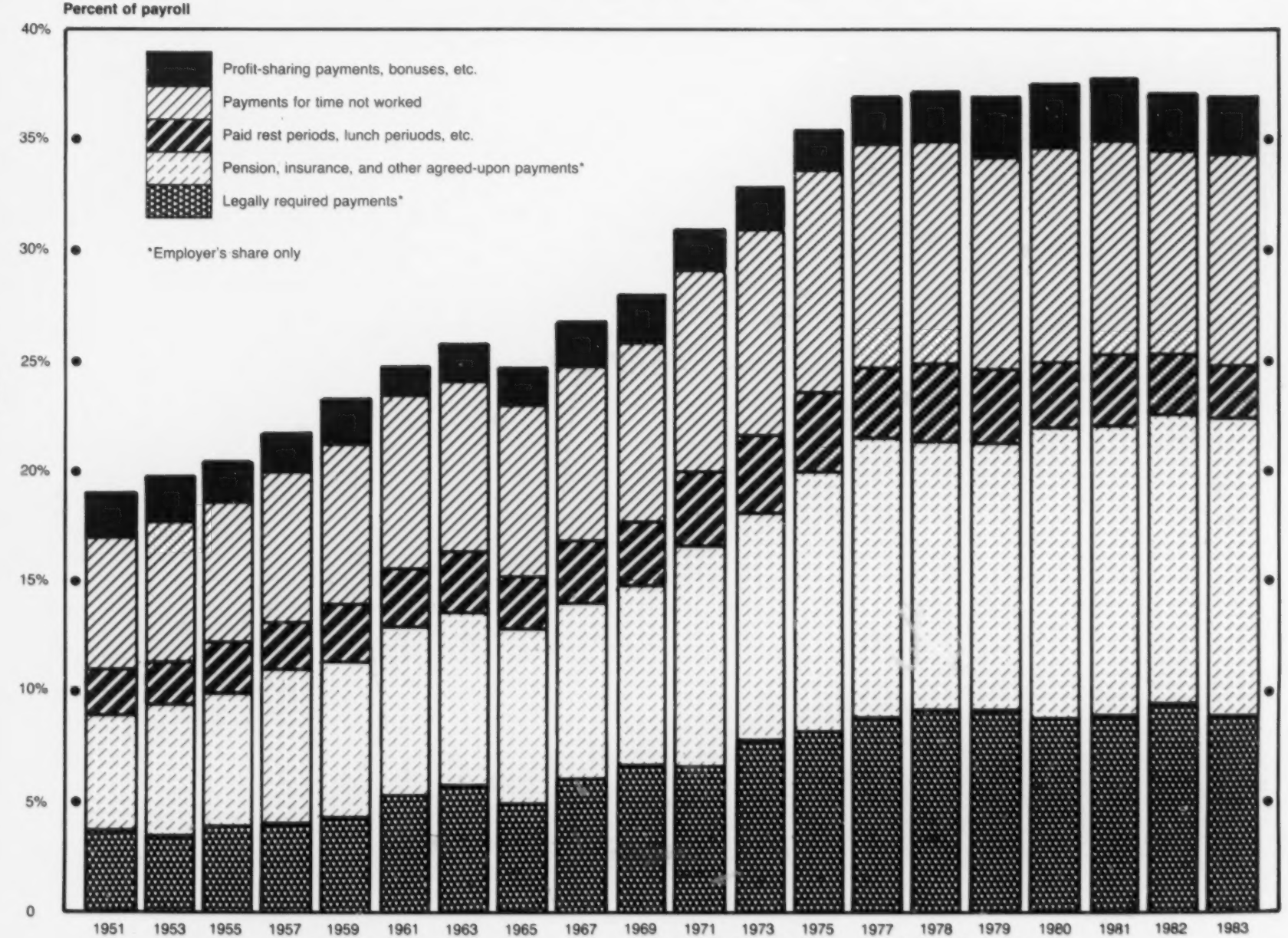
Trade Deficit - The trade deficit on a goods and services basis *decreased* from an annual rate of over $90.7 billion in the third quarter to $64.3 billion in the fourth quarter. The improvement is the result of a steep drop in imports which more than offset a slight decline in exports. The deficit for goods and services reached $66.3 billion in 1984, compared to only $8.3 billion in 1983, and surpluses of $19 billion and $28 billion in 1982 and 1981, respectively.

What's Ahead - The composite index of leading indicators, designed to predict future movements in aggregate economic activity, increased 1.3 percent in November. The November increase was the largest single month gain since February. It was also a widespread gain as nine out of eleven available indicators rose. This follows a revised 0.5 percent decrease in October and a 0.9 percent increase in September.

U.S. CHAMBER SURVEY FINDS INCREASE IN EMPLOYEE BENEFITS

The latest U.S. Chamber survey of employee benefits found that employers were paying an average of $7,582.00 per hourly rated employee for the year 1983. This was 5.5 percent more than they paid in 1982, notwithstanding great efforts on the part of employers to hold down the burgeoning costs of employee benefits. As the chart shows, there has been a dramatic increase in benefits as a percent of payroll between 1951 and 1983. For information about ordering *Employee Benefits 1983*, call (301) 468-5128.

Total Employee Benefits as Percent of Payroll, 1951 to 1983



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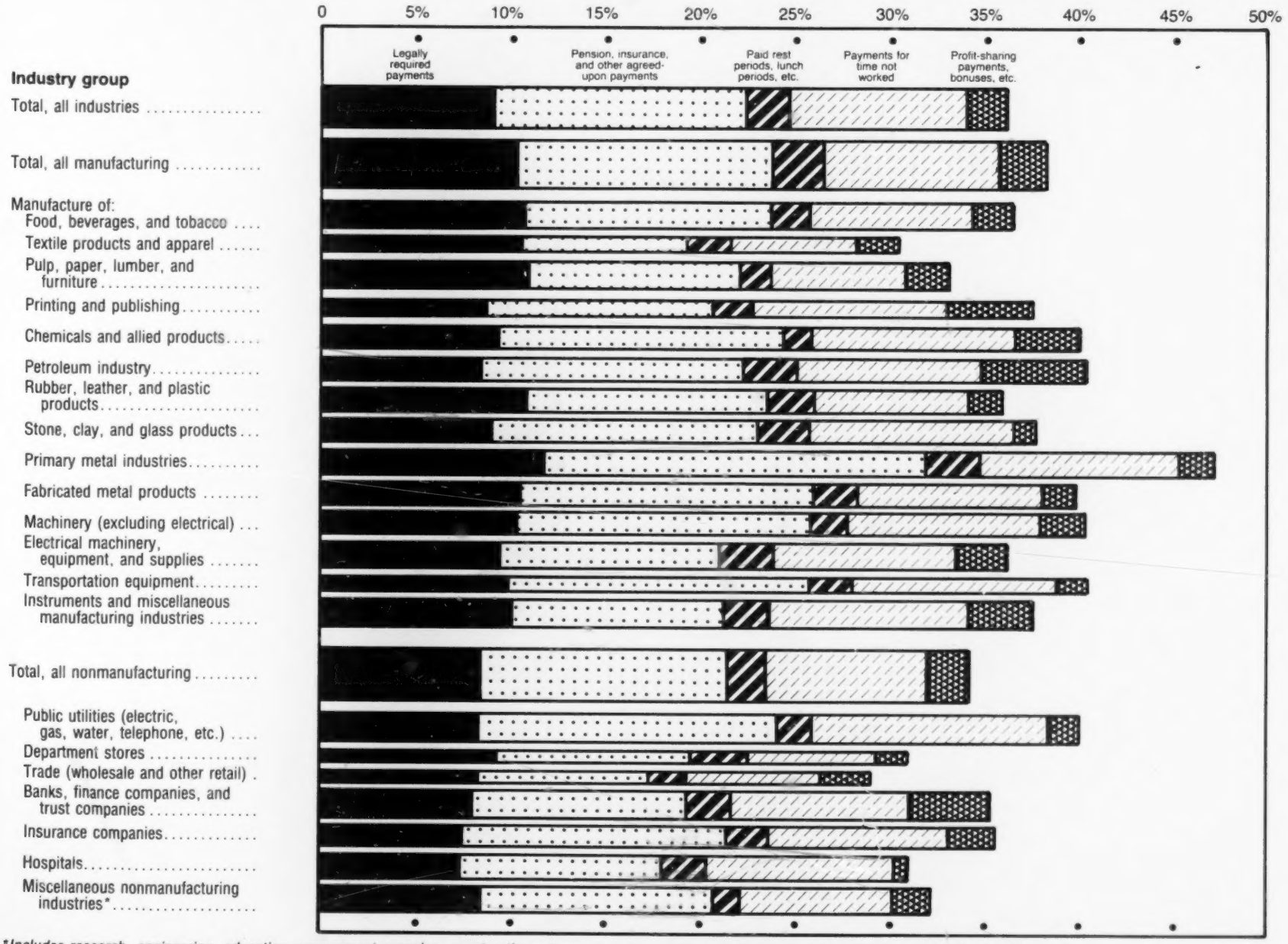
Employee Benefits as Percent of Payroll, by Industry Groups, 1,454 Companies, 1983



*Includes research, engineering, education, government agencies, construction, etc.

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